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Investment Strategy Insights

September 8th, 2020

Where's the Inflation?

- Deflating Market Excess
  - Last week reflected a deflating of excesses that had built up on one side of the market
- The Fed's "New" Inflation Target
  - The Fed's new plan primarily means a more accommodative monetary policy supporting risk assets
- Inflation's Uphill Battle
  - Expectations for meaningfully higher inflation appear premature, as price levels face a number of secular headwinds

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Deflating Market Excess

- **Equity Market Pullback.** After hitting its 22nd record high for the year earlier in the week, the S&P 500 fell a combined 4.3% on Thursday and Friday. The move came despite the U.S. unemployment rate for August reporting at 8.4%, much better than last month's 10.2% and strong readings from purchasing managers' indexes via Markit and ISM*. Much of the pullback appeared to be focused in the largest growth stocks, which had been showing signs of speculative behavior by smaller investors.

- **Growth Underperforms.** The technology sector, in particular, was down 7.1% cumulatively on Thursday and Friday after an incredible run year-to-date. which had been showing some signs of speculative activity with investors paying up for their recent superior business growth. Many of these companies had proven more resilient during the COVID-induced downturn. Some had even been relative beneficiaries due to their particular line of business – communications, online entertainment and online retail, to name a few. However, their valuations may have become too far stretched, even given their fundamental outperformance.

- **Another Value Head Fake?** On the other side, value stocks outperformed, closing down only 1.9% cumulatively on Thursday and Friday. This retracement is but a drop in the bucket compared to the performance gap between value and growth stocks over the last few years. The starting point disparity in valuations leaves open the possibility of an ongoing contraction in this gap; however, this outperformance may prove short-lived until a sustainable economic normalization is achieved via a widely available vaccine.

Last week reflected a deflating of excesses that had built up on one side of the market

The Fed's "New" Inflation Target

- **The Forceful Fed.** The Fed has been particularly proactive with respect to its pandemic economic response efforts. It slashed rates to zero in mid-March, embarked on a massive balance sheet expansion and acted as a lender of last resort in an effort to ease stress on funding markets and struggling businesses, priming the economy for a recovery on the other side of the pandemic. In its latest move, the Fed has announced revisions to its framework on inflation.

- **A Change in Inflation Framework.** Inflation targeting is a central banking approach that involves adjusting monetary policy to achieve a specific annual rate of inflation, based on the belief that long-term economic growth is best achieved by maintaining price stability. The Fed has historically operated with a 2% target. Now, the Fed has expressed that, in order to average out to 2% in the long run, they are prepared to allow inflation to rise above 2% for some period of time to offset recent periods of sub-2% inflation.

- **The Path Forward for Monetary Policy.** Investors should be careful not to misinterpret the Fed's new inflation target as a sign that price levels are primed to skyrocket in the near future. Above all else, its nuanced adaptation for inflation is an enhanced reinforcement for accommodative monetary policy. It signals that the Fed is committed to reflation, which affords them the opportunity to keep rates lower for longer in the short-/medium-term.

The Fed's new plan primarily means a more accommodative monetary policy supporting risk assets

**Institute of Supply Management (ISM)*

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Inflation's Uphill Battle

- **Rising, but Still Well Below 2.0%.** Inflation expectations have been rising from their March lows as the Fed has acted, COVID-19 fears have moderated from their peak and economies have begun to reopen. The announcement of the Fed's new framework for inflation targeting may also be providing a boost, but expectations still remain quite low. An aggregate of two market-based assessments of inflation expectations, one derived from the spread between yields on 10-year Treasury Bonds and 10-year TIPS** and another implied from the pricing of inflation swap contracts, point to inflation of 1.6% over the next decade.

- **Secular Headwind #1: Technological Innovation.** Over the long-run, inflation has faced a handful of secular headwinds that have kept a lid on price levels, one of which has been technological innovation. Moore's Law posits that the number of transistors able to be packed on to integrated circuit chips doubles roughly every two years, a thesis that has largely proven true since the 1970s. As a result, tech hardware and services prices have experienced persistent deflation, with price levels declining by ~4% annually since 2006.

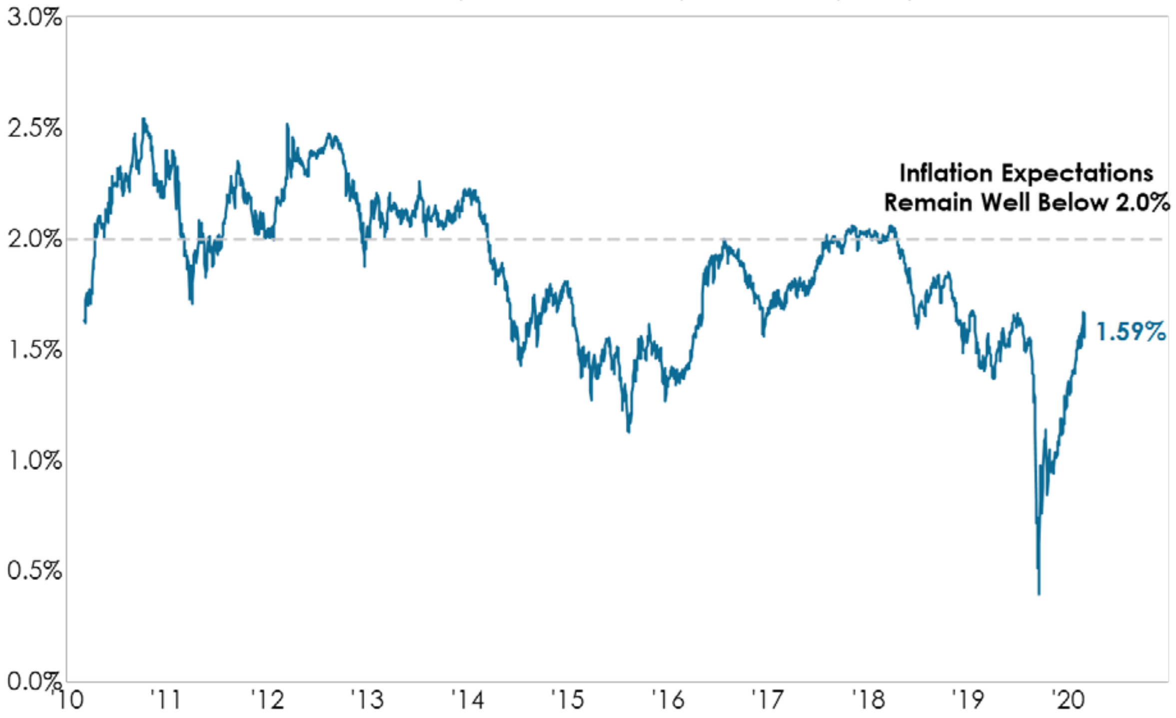
- **Secular Headwind #2: Demographics.** Another structural headwind for inflation has been demographics in the U.S. Higher birth rates have historically been followed by higher inflation, likely due to an associated rise in demand for goods and services. The birth rate in the US has sits at an 80+-year low of 0.59% per year after having been stuck below 0.7% for over four decades portending more subdued inflation.

Expectations for meaningfully higher inflation appear premature, as price levels face a number of secular headwinds

Chart of the Week:

Inflation Expectations Have a Long Way to Go

Market-Implied Inflation Expectations (10 Yr)



Source: Glenmede, Factset *Data through 09/04/2020*
Market Implied Inflation Expectations (10yr) are based a equal-weighted average of inflation implied by 10-year inflation swaps and inflation implied by the relative yields on 10-year Treasury Bonds and 10-year Treasury Inflation Protected Securities (TIPS). All inflation expectations are adjusted to reflect Personal Consumption Expenditures Inflation (PCE). Past performance may not be indicative of future results. Actual results may differ materially from market-implied expectations.

***Treasury Inflation-Protected Securities (TIPS)*

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